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IN THE

Supreme Court of the United States

OCTOBER TERM, 1957

No. 899

EDMUND THOMAS GULLEDGE, SR., and LUCY COULTER GULLEDGE, Husband and Wife, *Petitioners*

vs.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

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To the Honorable, Chief Justice, and the Associate Justices of the Supreme Court of the United States.

The petitioners, appellants below, pray that a Writ of Certiorari issue to review the Judgment of the United States Court of Appeals for the Fourth Circuit entered in the above cause on November 7, 1957. (Appendix 19a)

OPINIONS BELOW

The Tax Court of the United States did not render a written opinion in this cause. Its memorandum findings of fact and opinion was filed on February 13, 1957. (App. 1a)

The opinion of the United States Court of Appeals for the Fourth Circuit is set forth at page 15a of the Appendix.

JURISDICTION

The jurisdiction of the Court is invoked under Sec. 1254 (1), Title 28 of the United States Code.

The Judgment of the United States Court of Appeals for the Fourth Circuit here sought to be reviewed, was entered on November 7, 1957. An order extending the time to April 5, 1958 within which to file this petition for a Writ of Certiorari was entered on January 31, 1958.

QUESTIONS PRESENTED

I. Do payments made for the benefit of a corporation by an individual stockholder pursuant to his independent agreement with a third party result in losses under the provisions of Sec. 23(e), or in bad debts under Sec. 23(k) of the Internal Revenue Code of 1939 as amended?

II. If such payments are to be treated as bad debts, are they deductible as business bad debts under Sec. 23(k)(1) or as non-business bad debts under Sec. 23(K)(4) where the stockholder, a peanut grower, made the payments for the benefit of the corporation which processed the peanuts he grew?

III. Are loans made by a peanut grower-stockholder, directly to the Corporation which processed the peanuts grown by him, deductible as business or as non-business bad debts when not repaid?

STATUTES AND REGULATIONS INVOLVED

The pertinent statutes and regulations, set forth in the appendix, are

26 U.S.C. Sec. 23(e)
26 U.S.C. Sec. 23(k)
Treasury Regulations 111, Sec. 29.23(k)-6
Treasury Regulations 118, Sec. 39.23(k)-6

STATEMENT OF FACTS

Petitioners are husband and wife, residents of Sumter County, South Carolina. Edmund Thomas Gulledge, Sr., hereinafter referred to as petitioner, is a farmer who during all years material hereto farmed 1500 to 2000 acres of which approximately 400 acres were in peanuts. The total peanut acreage of Sumter County was about 4000 acres.

Prior to 1946, petitioner and the other peanut growers had no local or state market for their peanut crops. The nearest markets were 150 to 200 miles away in North Carolina. As a result the growers in Sumter County were at an economic disadvantage and not able to get fair prices for their crops because they were obliged to sell individually to itinerant buyers for whatever price they could negotiate.

In 1946, the Sumter County Farm Agent, aware of the dissatisfaction among the peanut growers of the county and their specific complaints as to lack of uniform grading, excessive haulage charges, packaging costs, prices obtainable, and delays in receiving payments, approached petitioner and two other large producers in the county and urged them to jointly establish a local market and processing plant. Together these individuals visited the markets and peanut companies in Georgia and Virginia to determine whether such a venture would be feasible. Upon receiving encouraging reports they formed the Sumter Peanut and Produce Corporation in July 1946.

On December 31, 1947, the capital of the Corporation and its stockholders were as follows:

Petitoner	155 Shares	$15,500
W. J. Lawrence	155 Shares	15,500
H. C. Edens	110 Shares	11,000
T. O. Bowen	60 Shares	6,000
	480 Shares	$48,000

The petitioner and the other farmer-stockholders each considered this operation as being directly related to, connected with, and a part of their farming activity. An immediate result was an increase in peanut prices to all the growers in the County of from $25 to $30 per ton.

At various times when the Corporation did not have the necessary funds with which to purchase peanut crops, petitioner and the other stockholders loaned funds. The total of the amounts so loaned by petitioner directly to the Corporation through February 1951 was $14,817.04.

It had been the practice of the Corporation to issue warehouse receipts for the peanuts as they came into the plant. These warehouse receipts were then required to be paid off before the peanuts were shelled. Late in 1951 however, it was discovered that the plant manager had been shelling peanuts before making payment. This, coupled with a decline in the market price of shelled peanuts of from $100 to $130 a ton, made it questionable that the Corporation would be able to pay off the outstanding warehouse receipts.

Petitioner and the other stockholders advised the South Carolina State Warehouse System, Agriculture Department, of the situation, and in their individual capacities, entered into the following agreement on November 29, 1951.

> "WHEREAS, the undersigned Stockholders and Directors of Sumter Peanut & Produce Corporation, do hereby assume reponsibility and personal liability for the retirement of all outstanding warehouse receipts in State Warehouses Nos. 1179-G, 1096-G, 1233-G; and
>
> WHEREAS, the undersigned parties do admit that they are responsible for said warehouse receipts no matter how many, and what amounts, together with all storage charges thereon, and agree to fully retire and counsel [sic] the same on or before the 15th day of December 1951.
>
> Now, THEREFORE, in consideration of the premises, we, the undersigned, do hereby bind ourselves to

retire and cancel all of said warehouse receipts, together with storage on or before December 15, 1951.

This Agreement shall be binding upon the parties hereto, their heirs and assigns.

Witness the hand and seal of the parties hereto this the 29th day of November, 1951.

/s/ E. T. Gulledge
W. J. Lawrence
R. E. Colvin

STATE OF SOUTH CAROLINA
COUNTY OF SUMTER

Personally appeared before me W. E. Pate, who, being duly sworn says that he was present and saw the within E. T. Gulledge, W. J. Lawrence, and R. E. Colvin sign, seal, and as their act and deed deliver the foregoing written Agreement and that he with M. M. Weinberg witnessed the due execution thereof.

Sworn to before me this the
29th day of November, 1951

/s/ W. E. Pate

/s/ M. M. Weinberg
Notary Public for S.C."

In discharge of the liabilities arising from the Agreement, petitioner subsequently paid $31,500. The other stockholders paid various lesser amounts.

The Tax Court of the United States had jurisdiction under 26 USC Sec.6213. The Court of Appeals affirmed the Tax Court's determination that upon failure of the corporation, petitioner realized only a non-business bad debt. Neither the Tax Court, nor the Court of Appeals made any distinction as between monies loaned directly to the Corporation and monies paid pursuant to the indemnity agreement set forth above.

ARGUMENT

Your petitioner respectfully urges this Honorable Court to grant the petition for a Writ of Certiorari prayed for in this cause for the following reasons:

(a) The questions here presented have not been settled by this Court, and are of national importance not only because of their impact upon the Federal Revenue and the large number of taxpayers involved but further because of the large volume of litigation resulting therefrom.

This Court in *Putnam* v. *Commissioner of Internal Revenue* (1966) 352 US 82, affirmed its previously stated views[1] that the loss provisions and bad-debt provisions of the Code[2] were mutually exclusive. It was further held that a guarantor's loss was deductible only under the bad-debt provisions, since by subrogation, a debtor-creditor relationship thereafter existed.

Historically, the deduction provisions of Sec. 23(e) and 23(k) have proved troublesome to taxpayers, the Government and Courts. Confusion has resulted because of their apparent overlap in many situations. Although the *Putnam* case does much to clear up some of the long existing confusion, there now remains to be established realistic guides or standards with which to extend the Putnam rationale into that still unsettled, but directly related area involving independent indemnity or quasi guaranty, surety and endorsement agreements where, absent subrogation, no debtor-creditor relationship results. Likewise, aids are needed to apply realistically the terms '*incurred in trade or business*', and '*incurred in any transaction entered into for profit . . .*', particularly in light of the fact that in either instance a loss is deductible in full, whereas a bad-debt is not, being limited by 23(k)(4) to only those occurring in a trade or business.

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[1] *Spring City Co.* v. *Commissioner*, 292 U. S. 182.

[2] Internal Revenue Code of 1939 as amended.

(b) The Opinion of the United States Court of Appeals for the Fourth Circuit in the instant case misinterprets the reasoning and logic of the *Putnam* case.

The holding of this Court in the *Putnam* case is that the loss and bad-debt provisions of the Code are mutually exclusive and the *sine qua non* to the application of the bad-debt section is the debtor-creditor relationship which may be direct and original, or may be indirect or collateral as where it results by virtue of subrogation.

In the instant proceeding, the Court of Appeals did not give consideration to the independent indemnity agreement entered into by petitioner which resulted in the major portion of his liability. This agreement establishes the legal status of the parties, and, being an indemnity, does not give rise to subrogation and no subsequent debtor-creditor relationship. The Court of Appeals ignores the legal distinction between funds paid pursuant to the indemnity agreement and those loaned directly to the Corporation, lumps them all together under the generic term 'loss' and concludes them to be non-business bad-debts.

Petitioner submits that the erroneous conclusion of the Court of Appeals results from their having assumed a false basic premise, directly caused by ignoring the *Putnam* rationale, to the effect that the debtor-creditor relationship is essential to the application of Sec. 23(k).

The Court of Appeals has therefore decided a Federal question in conflict with the applicable and controlling decision of this Court.

(c) Additionally, petitioner submits that the Court of Appeals erred in concluding that those funds advanced directly to the Corporation are non-business bad debts.

After finding that a business need existed for the Corporation, the Court then states:

> " . . . as a result the growers in the county obtained an advance from $25 to $30 per ton on the price of

their peanuts; and the investors testified that they considered the business of the Corporation as part of their farming operations. . . .

" . . . It is true that the taxpayer and the other stockholders were induced to contribute to the capital of the corporation in the hope that the establishment of a peanut mill in their neighborhood would enable them to secure a better price for their peanuts, and hence it may be said in a broad sense that the business of the farmers and the business of the Corporation were related." (App. 18a).

After so concluding, thereafter to find the advances to be non-business is a *non-sequitur* that represents not only a departure from accepted legal reasoning, but by its affirmance of the trial court, the Court of Appeals has also sanctioned that same error and illogical conclusion of the Court below.

I

Payments Made for the Benefit of a Corporation by an Individual Stockholder Pursuant to His Independent Agreement With a Third Party Result in Losses Under the Provisions of Sec. 23(e) rather than bad-debts under 23(k) of the Internal Revenue Code of 1939 as Amended.

The doctrine of the *Putnam case* requires the existence of the debtor-creditor relationship as a condition precedent to the recognition of a deduction under Sec. 23(k). This relationship may either be direct or the result of subrogation as a guarantor, endorser, or surety.

Absent the essential debtor-creditor relationship however, Sec. 23(k) is not applicable and any deduction is cognizable only under Sec. 23(e) as a loss.

For the purpose of these mutually exclusive provisions an indemnitor stands in a different legal position than does a guarantor or other person secondarily liable. The controlling principle is stated in *Howell* v. *Commissioner of*

Internal Revenue (CCA-8; 1934) 69 F. 2d 447; cert. denied 1934, 292 U.S. 654, as follows:

> "Although the ordinary surety or guarantor is a creditor of the principal debtor, the same cannot be true of an indemnitor who does not undertake to assume or discharge the obligations of another, but has, on his own account, contracted to pay a sum of money upon the occurrence of a certain event usually the happening or the ascertainment of a loss. There is no privity, either actual or implied, between the promisor in the undertaking the loss from the non-performance of which is indemnified against, and the indemnitor, and the latter, if the loss occurs, does not, by payment of it, discharge anyone's obligations but his own."

The petitioner-stockholder here paid the sum of $31,500 which although of indirect benefit to the Corporation was nevertheless his individual obligation paid pursuant to the independent agreement to which the Corporation was not privity. The obligation discharged was the primary liability of the individual petitioner and not a secondary or collateral liability. Since he paid no obligation other than his own, he had no legal right thereafter to look to the Corporation for reimbursement. There was no privity, no subrogation, nor any resulting debtor-creditor relationship.

The Court of Appeals failed to distinguish between those payments made pursuant to the agreement, and the loans made directly to the Corporation. That Court ignored the fact that petitioner had no right to look to anyone for repayment and erred by concluding that the loss thus suffered was deductible as a bad debt under section 23(k) despite the absence of the debtor-creditor relationship.

Absent the necessary condition precedent required by the *Putnam case* for the creation of a bad debt, and since the loss and bad debt provisions are mutually exclusive, logic requires that these payments if otherwise deductible be recognized only as losses under Sec. 23(e).

II

If Such Payments Are to Be Treated as Bad Debts They Are Then Deductible as Business Bad Debts Under Sec. 23(k)(1) Where the Stockholder, a Peanut Grower, Made the Payments for the Benefit of the Corporation Which Processed the Peanuts He Grew.

Petitioner urges in part I supra, that the $31,500 paid by him as an indemnitor should properly be allowed as a loss under Sec. 23(e). In the alternative, however, should this Court hold, as did the Court of Appeals, that such payments are deductible only as bad debts, petitioner then urges that they must be treated as *business* bad debts under Sec. 23(k)(1).

If all distinction between the indemnity payments of $31,500 and the direct loans to the Corporation in the amount of $14,817.04 is to be disregarded, the indemnity payments then assume the same legal character as the direct loans, and the argument that follows is equally applicable to both.

III

Loans Made by a Peanut Grower-Stockholder, Directly to the Corporation Which Processed the Peanuts Grown by Him Are Deductible as Business Bad Debts When Not Repaid.

Section 23(k)(1) allows, with exceptions not here pertinent, a deduction for the full amount of bad debts other than those defined as non-business bad debts by Sec. 23(k)(4).

The provisions of Sec. 23(k)(4) were added to the Code by the Revenue Act of 1942. The legislative intent and purpose sought to be accomplished by the enactment of this provision seems to be clearly established by the House Ways and Means Committee Report:[1]

> "C. Nonbusiness Bad Debts.
>
> "The present law gives the same tax treatment to bad debts incurred in nonbusiness transactions as it

[1] H.R. Rep. No. 2333, 77th Congress, 2d Session, p. 77.

allows to business bad debts. An example of a nonbusiness bad debt would be an unrepaid loan to a friend or relative, while business bad debts arise in the course of the taxpayer's trade or business. This liberal allowance for nonbusiness bad debts has suffered considerable abuse through taxpayers making loans which they do not expect to be repaid. This practice is particularly prevalent in the case of loans to persons with respect to whom the taxpayer is not entitled to a credit for dependents. This situation has presented serious administrative difficulties because of the requirement of proof."

The pertinent regulations are likewise helpful.[2]

"Nonbusiness-Bad Debts

"The character of the debt for this purpose . . . is to be determined . . . by the relation which the loss resulting from the debt's becoming worthless bears to the trade or business of the taxpayer. If that relation is a proximate one in the conduct of the trade or business in which the taxpayer is engaged at the time the debt becomes worthless, *the debt is not a nonbusiness debt for* the purposes of this section." (Italics supplied).

The legislative purpose for the enactment of Sec. 23(k)(4) as disclosed by the House Report *supra*, coupled with the official interpretation given to it by the Treasury Department which is responsible for its application, clearly indicates that the term "non-business bad debts" means only those which were neither incurred in a trade or business nor proximately related thereto. The application of Sec. 23(k)(4) was clearly intended to cover those bad debts that resulted from personal transactions having no legitimate business purpose.

Against this background it is difficult to see how the Court of Appeals can hold that the transactions here resulted in non-business bad debts

[2] Sec. 29.23(k)-6 of Regulations 111 and Sec. 39.23(k)-6 of Regulations 118.

The petitioner was a commercial grower of peanuts, one of the largest in the county. The welfare of these farmers; experience had shown, depended upon the facilities and services provided by the peanut processing Corporation. As a businessman, petitioner made the loans in an effort to protect the market for his product. This purpose is no less proximate to a business than protecting a source of supply. The debts here in question were not the result of loans to friends or relatives or debts that bore no relation whatsoever to the business in which petitioner was engaged, but, on the contrary were interrelated with, and inseparable from his business as a peanut farmer. It is fundamental that the business of being a farmer connotes as a necessary incident or adjunct thereto the processing and selling of the crop in the most advantageous manner. It is folly to hold that the business aspects of the farming operations cease at the moment the crop is harvested, and that activities thereafter are neither proximate to, nor a part of the business of farming.

The profit petitioner realized from his labors, and his resulting taxable net income were directly dependent upon the price for which he could sell his product. It is not disputed that local marketing problems had placed petitioner and others similarly situated at an economic disadvantage. As their product was perishable, the buyers could dictate the terms, nor was their economic bargaining position bettered by the costly transporting of their crops to established markets 150 to 200 miles away. The higher price they might there receive was more than offset by the additional expenses involved.

In an effort to improve the economic plight of these growers, the County Farm Agent induced the major growers to use their initiative to form a processing plant and thereby establish a local market. This was done and the immediate and direct result was an increase of

$25 to $30 a ton received by all local growers for their peanut crops.

At a later date, when the Corporation which purchased, warehoused and processed their crops, encountered financial difficulties, the petitioner and the other stockholders made direct loans to the Corporation. It is unrealistic to say that such loans were neither proximate to, nor directly related to their activities as peanut growers.

In holding that the taxpayer's losses in *Putnam supra* were non-business bad debts this Court stated:

> " . . . His venture into the publishing field was an investment apart from his law practice. . . . "

Here however, such was not the case. This was no venture into an unrelated field but rather an abiding effort on the part of this taxpayer to make a success of his peanut farming business. The economic facts of life forced this farmer to make these various expenditures, which included his investment in the capital stock of the Corporation (the loss of which is not here involved), his loans directly to the Corporation and his later losses as an indemnitor.

There are numerous decisions in which taxpayers similarly situated have been afforded "business bad debt" treatment. In *Estate of Robert Haverty*, T. C. Memo Op., Nov. 12, 1953 (Doc. Nos. 33832, 34463), the estate of the deceased taxpayer was allowed a business bad debt deduction for liability incurred pursuant to an instrument whereby he guaranteed the credit of the corporation which manufactured the furniture which his partnership was selling; in *Tony Martin* (1955), 25 T.C. 94, (acquiescence by Commissioner, 1956-1 CB4), the taxpayer's advances to a corporation formed to rejuvinate and rehabilitate his career were allowed as a business bad debt; in *J. T. Dorminey* (1956), 26 T.C. 940 a wholesale produce dealer was allowed business bad debt treatment for funds which he advanced to a

corporation organized to import bananas. The Tax Court held

> "The petitioner was a large shareholder and vice president of the debtor corporation. He was engaged in the produce business and had a market for about two carloads of bananas a week, but he could not obtain bananas because of economic conditions. Navigation [the corporation] was formed to bring bananas here from Central America and Cuba. Petitioner invested in Navigation for the purpose of obtaining bananas. The advances were incidental to and proximately related to his produce business. The resulting bad debt loss was incurred in trade or business and is deductible under Section 23(k)(1)."

See also, *Estate of Lawrence Weil* (1957), 29 T.C. No. 40; *Arthur Rubel et al.*, T.C. Memo. 1954-135; *Stuart Bart* (1954) 21 T.C. 890; *Robert Chutt, 3rd* (1947), 8 T.C. 1178.

CONCLUSION

The Fourth Circuit, by lumping loans made to the corporation with payments made pursuant to an indemnity agreement, and attaching the same legal character to each, has extended the doctrine of the *Putnam* case into a new and unintended field. We respectfully submit that this error alone is sufficient to grant the writ.

In addition, the failure to administer to these taxpayers the tax treatment to which they are entitled and which has been accorded other taxpayers in like circumstances, is clearly not "equal justice under the law." At the present time, there is a crying need for the establishment of realistic standards to distinguish between business and non-business bad debts. These can be provided only by this

Court, for which reason it is respectfully submitted that this writ be granted.

Respectfully submitted,

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